Personal Income Tax

Statewide Economic Growth and Taxation Issues in South Carolina

SC Department of Commerce

The personal income tax is the largest source of revenue for the General Fund in South Carolina (South Carolina), accounting for 46.6% of revenues in Fiscal Year (FY) 2009-2010. Between 2000 and 2005, personal income tax revenue hovered around $2 billion. Between 2006 and 2008, revenues increased sharply, ranging from $2.6 billion to $2.9 billion. However, in 2009, revenues decreased substantially by around 19% with $2.3 billion in personal income tax collected. While a decline was anticipated given the economic conditions of the state and nation as a result of the Great Recession, the magnitude of the decline was unexpected.

This study is a comprehensive, high-level analysis of the state's personal income tax system, identifying inefficiencies with the current income tax structure and developing recommendations for the implementation of an adequate, efficient, and equitable income tax structure that will provide revenue stability in periods of economic cycles.

BACKGROUND

South Carolina is one of 41 states that collects state personal income taxes. It follows federal income tax laws, allowing many of the same adjustments, exemptions, and deductions, with only a few modifications.

The state's personal income tax structure was created with the intent of being progressive. Tax brackets currently range from 3% to 7%. The 7% tax bracket is the 14th highest in the nation.

In 2008, South Carolina's tax burden—or the percentage of income taxpayers pay in state and local taxes—was 8.8%, below the national average of 9.7%. Bordering states, North Carolina and Georgia, had tax burdens of 9.8% and 9.9%, respectively.

State-level personal income tax collections for South Carolina were $748 per capita in 2008, below the national average of $918 per capita and lower than both North Carolina's ($1,201) and Georgia's ($920).

BRIEF OVERVIEW OF ECONOMIC MODELS & ISSUES

Taxes are levied for the primary purpose of adequately covering government expenditures. When considering an optimal form of taxation, the balance of equity and efficiency is often considered. Equity measures the partiality of the tax, and efficiency measures how close to market equilibrium the economy remains in response to the imposed tax.

The personal income tax has several features that often offset the balance of equity and efficiency thereby propagating negative effects in the marketplace. These effects include factors such as an excess or shortage of labor supply, human capital, entrepreneurship, and investment. Salient features of the personal income tax are as follows.

Marginal Tax Rates

The marginal tax rate is the rate on the last dollar of earned income and differs from the average tax rate, which is the percentage of total income paid in taxes. Thus, it is possible for individuals qualifying for substantial deductions and exemptions to face a moderate average tax on income but also face a high marginal tax on any activities that increase income, investment, or entrepreneurship.

Higher taxes on labor income discourage labor supply and output. This result is due to the fact that the reward to additional work has been reduced in the face of the new tax. While labor supply is often equated to the number of hours worked, this measure is, alone, very simplistic. Contribution to output also depends on an individual's effort as well as the individual's level of human capital. Thus, higher marginal tax rates may not simply incentivize people to work less, but they may also induce people to acquire less training (human capital) or accept easier but less productive jobs. These scenarios impact human capital investment and entrepreneurial activities.

Empirical studies substantiate this modeled effect. Countries with lower tax rates have more human capital and hence output than those with high marginal tax rates (Prescott 2004). High marginal tax rates have also been found to reduce work potential and effort (Karabegovic et. al. 2004).

The subsequent link to statewide and nationwide economic growth is established as well. Governments imposing low marginal tax rates have the fastest growing global economies (Barro and Sala-i-Martin 2004).

Deadweight Loss

Higher tax rates on higher tax brackets result in greater inefficiencies, or deadweight loss. Deadweight loss is the value of work that would have taken place but does not because of tax incidence.

The tax revenue is a transfer of wealth from the marketplace to the government, but the deadweight loss is the amount of work that would have taken place but does not occur due to the tax incidence. Thus marginal taxes that discourage output that would have existed without tax incidence are deemed inefficient.

As taxes rise, deadweight loss rises faster than the revenue raised by the tax. Thus, individuals alter their behavior with tax incidences, and distortions exist (Trostel 1993). Optimal tax incidence minimizes these distortions and deadweight loss.

PERSONAL INCOME TAX HISTORY IN SOUTH CAROLINA

The personal income tax was instituted in 1921 with the purpose of eliminating the use of property tax revenue at the state level. The tax, based on the Federal Tax Act of 1921, taxed individuals and corporations one-third of the amount owed in Federal taxes. The 1926 state Income Tax Act created the foundation for the current state income tax, taxing a percentage of personal income and corporate income. And, in 1985, South Carolina adopted conforming legislation to most of the Federal income tax system under the Internal Revenue Service code.

A Timeline of Major Changes

Several laws enacted in the past decade that have affected the personal income tax structure in the state, namely:

1. Federal Jobs and Growth Tax Relief Reconciliation Act (2004)
2. Reduced tax rates for pass-through entities (2006)
3. 2.5% tax bracket elimination (2007)

The Federal Jobs and Growth Tax Relief Reconciliation Act increased the standard deduction for some married couples.

In 2006, South Carolina reduced the tax rates for pass through entities (e.g.-sole proprietorships, partnerships, S-corporations, and Limited Liability Companies filing as one of the aforementioned types) from the graduated income

Table 1: South Carolina Individual Income Tax Brackets, 1959 Vs. 2010

Tax Rate	Starting Income (1959)	Starting Income (2010)	Starting Income (CPI-Adjusted from 1959)
2.5%	$0	-	$0
3%	$2,000	$2,670	$14,700
4%	$4,000	$5,340	$29,400
5%	$6,000	$8,010	$44,100
6%	$8,000	$10,680	$58,900
7%	$10,000	$13,350	$73,600

Source: SC Department of Revenue; US Bureau of Labor Statistics tax bracket ranging up to 7% to a flat 5% rate. This change was phased in over four years, having been fully implemented in 2009.

Prior to fiscal year 2008, South Carolina had six tax brackets with the lowest bracket having a rate of 2.5% and the highest a rate of 7%. The elimination of the 2.5% tax bracket in 2007 effectively created a lowest tax bracket of zero percent. This change was enacted in 2008. Thus, in 2008, individuals no longer had any tax liability on the first $2,630 of income.

The threshold for each tax bracket is adjusted annually to offset inflation. This adjustment is made in terms of the Consumer Price Index (CPI) but at the discretion of the South Carolina Board of Economic Advisors.

South Carolina's Current Individual Income Tax

South Carolina's six tax brackets and the taxable income ranges for each are shown in Table 1. Compared with 50 years ago, the state's tax brackets have not varied much. In fact, had the taxable income thresholds been adjusted each year for inflation, they would currently be 5.5 times larger than the taxable income thresholds for 2010, as also shown in Table 1.

Over time, tax bracket changes have not kept pace with inflation, moving taxpayers into higher tax brackets with higher marginal tax rates.

Tax credits having the most substantial impact on state revenue are those for non-residents, two-wage earners and childcare. Non-resident credits amounted to $165,729,013 in 2008, accounting for 62% of all tax credits. Two-wage earner credits accounted for 18% and childcare credits accounted for 7.5%. These three credits accounted for 87.5% of all tax credits in the state.

South Carolina Versus Other States

All of the southeastern states have various personal income tax structures, with the exception of Florida which has no personal income tax. Tennessee is also a special case as it only taxes dividends and capital gains. Compared with the seven other southeastern states, South Carolina's top personal income tax bracket of 7% ranks second highest, only behind North Carolina which has a top tax bracket of 7.75%. See Table 2. However, the combination of the high rate and the threshold at which this top rate is applied is significantly lower than any of the other southeastern states and one of the lowest in the nation.

South Carolina is one of nine states (Colorado, Idaho, Minnesota, North

Table 2: Southeast United States Individual Income Tax Rates & Deductions, 2010

State	Highest Marginal Tax Rate	Top Tax Rate Income Threshold	Standard Deduction (Single)	Standard Deduction (Joint)	Personal Exemption (Single)	Personal Exemption (Dependent)
Alabama	5%	$3,000	$2,000	$4,000	$1,500	$300
Georgia	6%	$7,000	$2,300	$4,300	$2,700	$3,000
Louisiana	6%	$50,000	NA	NA	$4,500	$1,000
Mississippi	5%	$10,000	$2,300	$4,600	$6,000	$1,500
North Carolina	7.75%	$60,000	$3,000	$6,000	$2,000	$100 credit
South Carolina	7%	$13,350	$5,700	$11,400	$3,650	$3,650
Virginia	5.75%	$13,000	$3,000	$6,000	$930	$930

Source: SC Department of Revenue; Tax Foundation

Carolina, North Dakota, Oregon, Utah, Vermont) that uses the federal taxable income as the state's starting point for calculating personal income taxes. This starting point is determined by subtracting itemized or standard deductions as well as personal income exemptions from federal adjusted gross income (AGI). As a result, South Carolina accepts all Federal standard deductions and exemptions (adjusted annually for inflation), which are higher than other states' own deductions and exemptions. Twenty-seven of the 41 states imposing a personal income tax use AGI as the starting point for calculating state income taxes.

Among the nine southeastern states, North Carolina also uses the Federal taxable income as the starting point for determining taxable income. However, North Carolina does not accept Federal standard deductions and exemptions but instead uses deductions and exemptions from AGI, which are lower than those applicable to Federal taxable income. South Carolina is the only southeastern state that modifies its deductions and exemptions annually for inflation.

South Carolina has more generous deductions than any other southeastern state (see Table 2). Alabama has a progressive deduction system as income increases, not to exceed $2,500 for single filers and $7,500 for married couples filing jointly. North Carolina's deductions and exemptions are deductions from Federal AGI. Since North Carolina's tax base is Federal taxable income, they require the difference between the Federal deductions and exemptions and state deductions and exemptions be added back to taxable income.

All southeastern states have standard deductions and exemptions ranging from $2,000 to $4,500 for single filers and from $3,000 to $9,000 for married couples filing jointly. South Carolina's standard deduction is $5,700 for single filers and $11,400 for married couples filing jointly.

South Carolina also has the highest personal income exemption of any southeastern state at $3,650. Standard deductions and exemptions, coinciding with the fact that South Carolina uses Federal taxable income as a starting point explain why South Carolina generally has a lower taxable income and tax liability than other states.

To illustrate the magnitude of the gap between deductions and exemptions in South Carolina versus other states, consider the scenario in which Georgia's standard deductions are applied to South Carolina's taxable income for FY 2007-2008. The total amount of standard deductions was $2.35 billion less for single filers and $5.82 billion less for married couples filing jointly, resulting in deductions totaling $8.17 billion less than South Carolina's deductions. In addition, because South Carolina increases its standard deductions for inflation yearly while Georgia does not. This indexation serves to expand the gap between the two systems.

South Carolina (along with Mississippi and Virginia) possesses the same tax brackets for both single filers and married couples filing jointly. This is different from its border states, Georgia and North Carolina, which increase the tax bracket for couples that are married and file jointly. South Carolina also differs from Alabama and Louisiana. These states double the base for each tax bracket for married couples filing jointly. Thus, the tax liability for couples who are married and filing jointly is higher than it would be in Alabama, Georgia, Louisiana, and North Carolina.

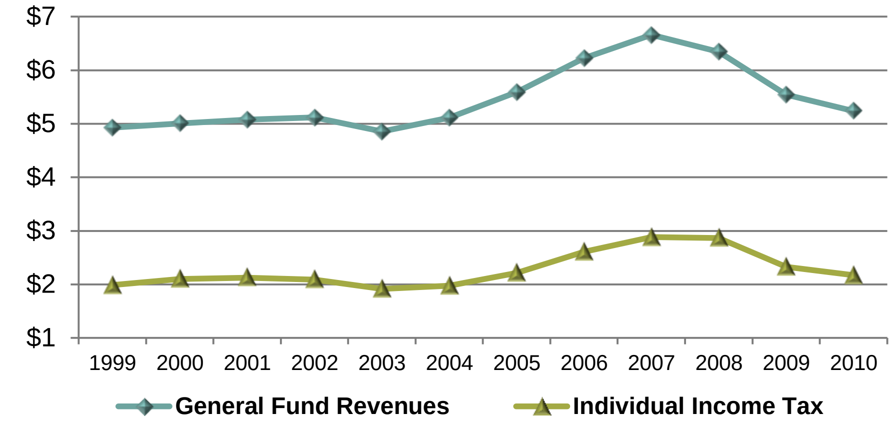
Most of the deductions and exemptions in southeastern states concern Social Security income, childcare, and tuition payments as do South Carolina's.

South Carolina, along with all other southeastern states, does not tax Social Security benefits. It is also one of five states (others are New Jersey, Ohio, Oklahoma, and Pennsylvania) that exempts disability retirement income from personal income taxes. Georgia and North Carolina conform to the Federal disability income tax regulations, where one is required to pay Federal income taxes if total income is above $2,500 for an individual and above $3,200 for a couple.

STATE PERSONAL INCOME TAX REVENUES

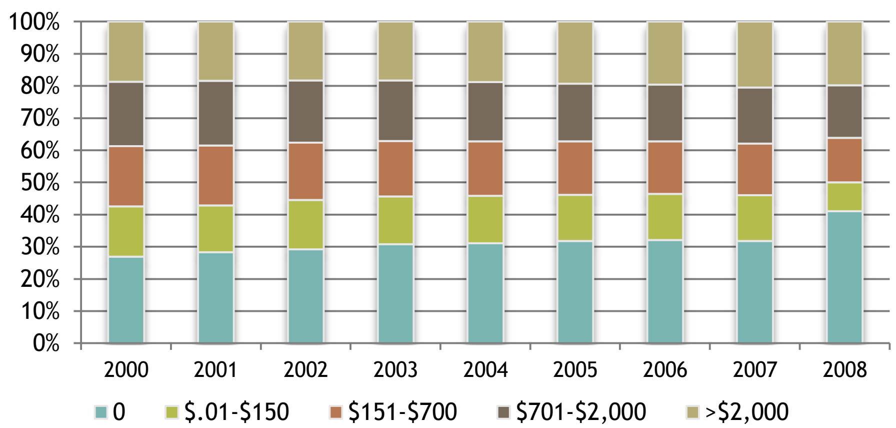
As the largest source of revenue for the state general fund in South Carolina (44% in 2008), personal income tax revenue is a crucial component for education as well as health and social services funding.

FIGURE 1 Individual Income Tax and General Revenues (in billions)



Sources: Comptroller General's Year End Press Release, FY 2010

FIGURE 2 Returns Filed by Tax Liability



Sources: SC Department of Revenue

A Detailed View of Personal Income Tax Collections

South Carolina has witnessed varied year-over-year personal income tax revenue in the past decade, as shown in Figure 1.

From 1999 to 2001 steady personal income tax growth occurred. However, this period was followed by a decrease from 2001 to 2003, due in part to the nationwide recession as well as the September 11th attacks.

Personal income tax revenue began increasing in 2003 and continued until 2006. South Carolina witnessed double-digit growth rates between fiscal years 2004 and 2006. Personal income tax revenue entered another period of decline in 2007, decreasing by as much as 19% between 2008 and 2009. This decline is attributed to both the elimination of the 2.5% income tax bracket and the impacts of the Great Recession.

Returns by Liability

Considering the return type by the amount of tax liability, a tremendous disparity exists. From fiscal years 2000 through 2008, an average of 31.4% of all personal income tax returns filed was from individuals with a tax liability of zero. Individuals with a tax liability of over $10,000 represented only 1.4% of the returns filed from 2000 through 2008, on average. And, individuals with a tax liability over $1,000 comprised 3.2% of all returns, on average, from 2000 through 2008.

The number of taxpayers with no personal income tax liability has been rapidly increasing since 2000, when 27% of those filing income tax returns had no personal income tax liability. (See Figure 2) In 2008, 41% of individual filers had no income tax liability. The extreme increase in individuals with no income tax liability resulted from the elimination of the 2.5% income tax bracket.

Liability by Taxable Income

A similar trend is observed when analyzing tax liability by taxable income. Individuals in the highest tax bracket (7%) with a taxable income greater than $13,150 for tax year 2008, comprise 42% of the returns filed and bear 96% of the tax liability. (See Figure 3)

Credits and Deductions

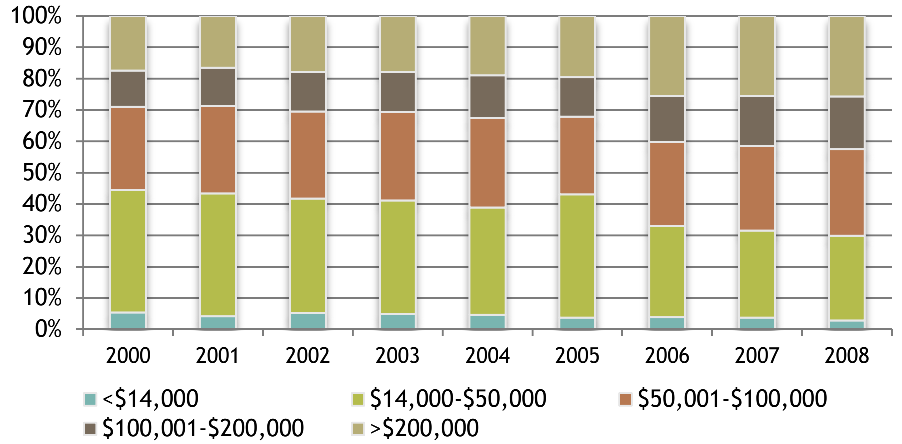
As addressed previously, South Carolina has substantially higher standard deductions and exemptions than any other southeastern state. In addition, South Carolina also has targeted deductions and advantages. One such deduction applies to net capital gains, on which a 44% deduction is allowed.

Another such targeted advantage lies in the disparity of taxation of income from W-2 wages versus Schedule C income. Although not formally termed a deduction, Schedule C income (or income as an independent contractor or from a pass-through entity) is taxed at a flat rate of 5% rather than the standard progressive income brackets that peak at 7%.

Social Security income is exempt in South Carolina. A $3,000 deduction on qualified retirement income for individuals under the age of 65 and a $10,000 deduction for individuals 65 and over are also allowed per individual. Thus, a couple 65 or older with qualified retirement income that is married and filing jointly is eligible for a $20,000 deduction. In addition, a $15,000 income deduction exists for individuals 65 and older if married and filing jointly.

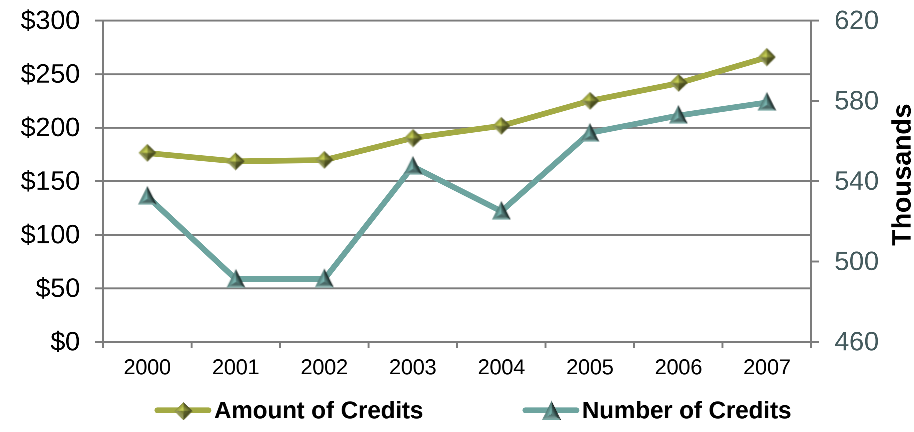
South Carolina allows 36 personal income tax credits. The most substantial are the non-resident credit, accounting for 61% of all credits, followed by the two-wage earner credit (22%) and the child care credit (9%). The value of personal income tax credits has been steadily increasing since 2002. (See Figure 4)

FIGURE 3 Returns Filed by Tax Liability



Sources: SC Department of Revenue

FIGURE 4 Individual Income Tax Credits (in millions)



Sources: SC Department of Revenue Annual Reports

The County Level

South Carolina has 46 counties with varying personal income tax liability across all of them. These revenue differences come from differences in income level, poverty rate, cost of living, size of the population, and regional economic development.

Beaufort, Charleston, Greenville, Lexington, and Richland counties were the five counties with the highest per capita income tax liability in 2008 (See Appendix). On the other end of the spectrum were Abbeville, Cherokee, Darlington, Laurens, and Pickens counties with the lowest per capita tax liability.

Average effective income tax rate measures the ratio of the state tax liability to the state taxable income. State tax liability is the actual tax each individual owes to the state subtracting non-refundable tax credits.

The average effective income tax rate ranged from 1.87% in York

County to 3.95% in Bamberg County in 2007. The state average effective income tax rate was 3.43%. 42 counties were below the state average. York and Lancaster counties may exhibit a lower average effective income tax rate, in part, due to the fact that the two counties border Charlotte, NC and may have residents who work in North Carolina.

KEY ISSUES & RECOMMENDATIONS

High Marginal Tax Rates on Low Taxable Income

South Carolina has the highest marginal tax rate on the lowest level of taxable income in the Southeast (and third in the nation).[1] This situation has evolved over a number of years as changes in tax bracket levels have not kept pace with inflation. As shown in Table 1, if the 1959 tax bracket levels were indexed to inflation, they would be 5.5 times higher in 2010 than they currently are.

While indexing the tax brackets is periodically performed, it is only done at half the rate of the Consumer Price Index (CPI) growth and cannot exceed a maximum of four percent per year. Thus, many individuals are catapulted into higher tax brackets quicker than the rate at which their wages increase. This phenomenon serves as an implicit tax increase.

The high marginal tax rate is coupled with the fact that South Carolina allows larger standard deductions and exemptions than most southeastern states. As a result, South Carolina's income tax structure resembles a high flat tax with large income exemptions or a sharply progressive structure with effectively two-tiers—0% and 7%. As this trend continues, an increasing number of individuals will bear no tax liability, and the tax burden will fall on fewer and fewer individuals.

Reversing this trend and broadening the tax base can result in lower rates overall, which promotes both equity and efficiency. Also, by reducing tax rates, workers, investors, and business owners have more incentive to acquire human capital, pursue entrepreneurial activities, work overtime, and make investments.

A Federal Reserve Bank of Atlanta study examined how state and local taxes affect state economic growth and found that there is a significant negative correlation between state marginal tax rates and state economic growth. South Carolina has one of the highest marginal tax structures in the country. By cutting the rates, South Carolina will become more competitive.

Increasing Number of Taxpayers with $0 Tax Liability

In 2008, 41.0% of individual filers paid no state income tax. In 2000 that figure was 27.0%. The declining tax liability can be attributed, in part, to several factors:

South Carolina's income tax structure resembles a high flat tax with large income exemptions or a sharply progressive structure with effectively two-tiers —0% and 7%.

Federal Taxable Income Versus Adjusted Gross Income

South Carolina uses federal taxable income rather than AGI as the starting point for calculating state taxable income, after federal deductions and exemptions have already been removed.

Using AGI instead of federal taxable income when computing personal income taxes, would broaden the tax base, simplify the tax structure, and ameliorate inefficiencies caused by federal exemptions that are not available to everyone. AGI, by not including standard and itemized deductions, raises the taxable income.

South Carolina and North Carolina are the *only* southeastern states that use federal taxable income as the starting point for calculating state income taxes. Having a state personal income tax that is not tied to the federal tax code would also provide more stability in times of tax policy changes at the federal level, and would hence provide

[1] Idaho has 8 tax rates ranging from 1.6%-7.8%. Individuals in the 7.1% tax bracket include those making between $6,605 and $9,907. Idaho accepts all Federal deductions and exemptions, just like South Carolina. Oregon has 5 tax rates ranging from 5%-11%. Those making between $3,049 and $7,650 are taxed at 7%. However, Federal taxes are deductible up to $5,600. Oregon's deductions are: Single-$1,945, Married $3,895 and personal exemptions are $176.

more revenue stability and predictability for the state.

Deductions

South Carolina then applies state standard deductions and exemptions which are higher than other southeastern states, further reducing the level of taxable income. Additionally, targeted tax credits and deduction amounts have been increasing in value.

2.5% Tax Bracket Elimination

In 2007, the 2.5% tax bracket was eliminated, allowing the first $2,670 of taxable income (after all the deductions and exemptions) to be tax free.

Targeted Credits and Deductions

While the purpose of itemized deductions and exemptions is to encourage specific economic activities and reduce potential hardships, they may create a means for tax avoidance and inequity. All exemptions, deductions, and tax credits create loopholes in the tax code and set one group (the one receiving the tax break) at a particular advantage over another (the one not receiving the tax break). Additionally, deductions and exemptions lower taxable income thereby decreasing revenue for the state.

Several important deductions, in terms of favoring one situation over another and impacting state revenues include the following:

State Standard Deductions

The federal tax system is more progressive and has higher tax rates than South Carolina, which is why federal deductions and exemptions are often much higher than those at the state level for personal income tax. Deductions and exemptions should accurately reflect the tax brackets and tax rates of the entity that is being taxed. South Carolina, however, uses the federal levels as its own state levels.

Retirement Income

Qualifying retirement income is deductible at rates of $3,000 per individual before age 65 and $10,000 per individual afterwards. Additionally, those 65 and over receive an additional $15,000 income deduction, and all social security income is exempt from state taxation. The number of filers claiming these deductions is anticipated to increase rapidly with the retirement of the baby boomers. Additionally, the percentage of elderly population in poverty is declining, statewide and nationwide (13.9% in 2000 vs. 12.1% in 2008), while the percentage of children under 18 in poverty is increasing (18.5% in 2000 vs. 21.8% in 2008)

Schedule C Income

In 2006, the income tax rate of pass through entities was reduced in increments of 0.5% per year to a rate of 5% by 2009. This change was intended to provide tax parity between large C-corporations, who were taxed as an entity at 5% before profit distribution, and small businesses whose profits are taxed as Schedule C income on individual income tax returns. As a result of this change, individual filers of income reported on Schedule C of form SC-1040 pay income tax at a lower rate (5%) than filers who report income from W-2 wages or dividends (7% for taxable income over $13,350). Furthermore, pass-through entities, by definition, are not taxed, whereas C-corporations are. Thus, shareholders in C-corporations must pay the 5% corporate tax on profits of the entity, followed by individual income tax on dividend distributions (7% for taxable income over $13,350). Even if the shareholder is an employee and can take most of the earnings in the form of W-2 wages, those are still taxed at the higher 7% rate.

CONCLUSION

In general, South Carolina's individual income tax system has become more focused and narrow, as fewer individuals bear a greater percentage of the tax burden.

Reducing the marginal tax rate, indexing tax brackets for inflation, reducing dependency on federal taxable income, evaluating the equity of targeted deductions and exemptions, will serve as a catalyst for instituting a more equitable, efficient, stable, and simple personal income tax structure.

The personal income tax is one part of a whole in South Carolina's tax structure. Any changes to one should be evaluated comprehensively across all elements to ensure they operate in concert.

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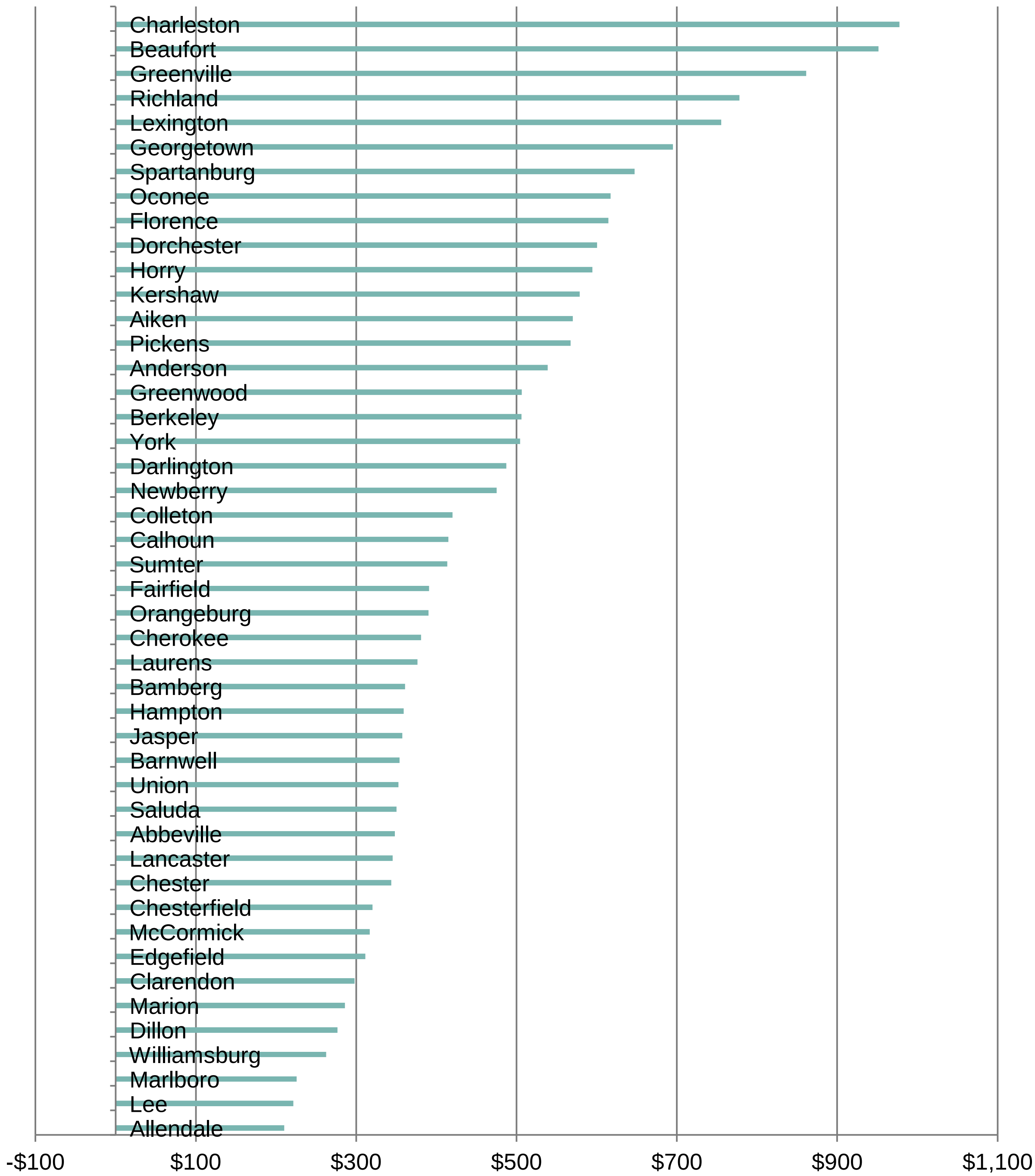
APPENDIX

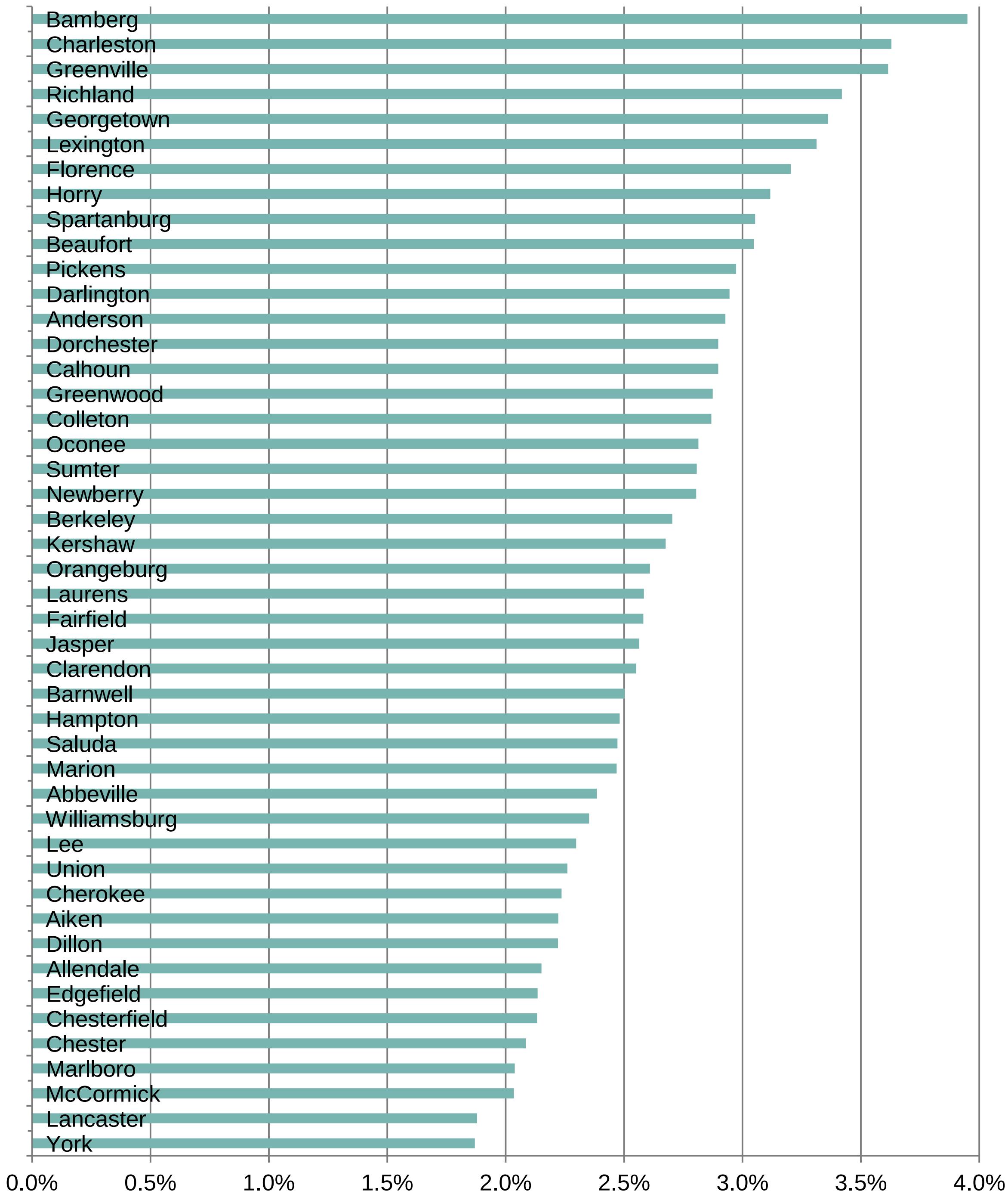
FIGURE A1 **Per Capita Indivdiual Income Tax Liability by County, 2007**



Source and notes:Per capita individual income tax is total tax liability divided by mid-year population in 2007. Total tax liability is from South Carolina Department of Revenue Annual Report 2007-2008. Mid-year population is from the U.S. Census Bureau, population division.

FIGURE A2

Average Effective Income Tax Rate by County in 2007



Source and notes: South Carolina Department of Revenue Annual Report 2007-2008

Table A1: South Carolina Standard Deductions and Exemptions ($)

Tax Year	Standard Deductions		Personal Exemptions	
	Single	Married	Single	Dependent
2000	4,300	7,200	2,750	2,750
2001	4,400	7,350	2,800	2,800
2002	4,550	7,600	2,900	2,900
2003	4,700	7,850	3,000	3,000
2004	4,750	7,950	3,050	3,050
2005	4,850	9,700	3,100	3,100
2006	5,000	10,000	3,200	3,200
2007	5,150	10,300	3,300	3,300
2008	5,350	10,700	3,400	3,400
2009	5,450	10,900	3,500	3,500
2010	5,700	11,400	3,650	3,650

Table A2. South Carolina Individual Income Tax Credits (Fiscal Year 2008)

Individual Income Tax Credits	Number of Credits	Total Amount of Credits ($)	% of Total Amount of Credits
A credit is allowed for income taxes paid to another state on income which is taxable in both states	75,098	165,729,013	62.34
Qualified retirement plan	490	1,012,099	.38
Two wage-earners credit	377,766	48,202,108	18.13
Credit for care expenses on dependent child under age 13 and disabled spouse	115,919	19,917,510	7.49
25% of tuition for each taxable year up to $850 for a 4-year institution and up to $350 for a 2-year institution	7,670	5,193,332	1.95
New Jobs Credits	361	7,255,598	2.73
Qualified Conservation	222	6,913,672	2.6
Economic Impact Zone	177	1,363,396	.51
20% of the expenses on nursing facilities up to $300 each tax year	206	55,887	.02
Other 25 types		10,207,731	3.84
Total		**$265,850,346**	**100%**